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Legal Risk Management Tip
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CONSIDERATIONS FOR MARKETING PRIVATE EQUITY FUNDS

The ability of a private equity fund's manager to obtain capital commitments from investors is critical to the fund's success. Unlike hedge funds which provide managers with the ability to reinvest non-withdrawing investors' investment proceeds, private equity funds have relatively limited reinvestment ability and generally must distribute investment proceeds to its investors. Therefore, in order to keep making new investments, private equity fund managers must create and finance new funds every few years, which then requires new promotional materials for each new fund.

The promotion of private equity funds continues to be a regulatory hot topic. This month's Legal Tip focuses on the most common strategies employed by private equity managers to promote a new fund and provides guidance on regulatory factors that must be considered prior to distribution of private fund materials.

General Marketing Considerations

Private equity funds are commonly structured as limited partnerships, and fund managers raise capital for the fund by selling limited partnership interest to investors. The limited partnership interests are typically sold in reliance on an exemption from registration found under Rule 506 ("Rule 506") of the rules promulgated under the Securities Exchange Act of 1933 ("Securities Act"). Rule 506 provides a safe harbor by which offerings of securities that comply with its terms will be deemed to be exempt from registration under the private sale exemption provided for in Section 4(2) of the Securities Act. Private equity fundraising through a Rule 506 offering is typically marketed through a series of one-on-one meetings with potential investors to present the fund opportunity.

Up through September 2013, there could be no advertising or general solicitation of investors in a Rule 506 offering. Activities that would likely be considered to be a general solicitation include advertisements (including advertised seminars or presentations) and articles or other communications published in any newspaper, magazine or other media or broadcast over television, radio or on the internet.

However, all of this changed in September 2013, when the Securities and Exchange Commission ("SEC") amended Rule 506 to add a subpart (c) to Rule 506 which provides an option for general solicitations and advertising to take place in connection with a private placement of securities. The traditional, non-general solicitation manner of offering was retained under subsection (b) of Rule 506. The increased flexibility to advertise an offering under Rule 506(c) may be an attractive feature to first-time managers and others as a means to expand their pool of potential investors. However, such flexibility comes at a price. Offerings and sales of securities under Rule 506(c) are strictly limited to accredited investors, and the rules place a burden for the managers to affirmatively confirm accredited investor status, rather than being able to rely upon an investor's representation as to status in a subscription agreement or similar document (as issuers had been able to do in traditional Rule 506 offerings and may still do in Rule 506(b) offerings). In addition, managers conducting a Rule 506(c) offering must submit certain regulatory filings with hard deadlines in connection with the offering, and the failure to timely make those filings could result in a loss of the Rule 506(c) private placement exemption.

Common Means Used to Promote Private Equity Fund Opportunities

The Private Placement Memorandum

The primary document for communicating relevant information about a private equity fund opportunity is the private placement memorandum ("PPM"). PPMs contain information that is material to an investor's decision to make a capital commitment to a fund. A well-prepared PPM will contain a clear, concise description of the fund, its investment strategy, its investment team and track record. It will also provide a summary of the fund's partnership agreement and other legal and tax disclosures. The PPM is usually a substantial document that serves two critical functions: First, it operates as legal disclosure of important matters affecting the fund and its investors. Second, the PPM acts as a marketing document by explaining, and hopefully heightening interest in, the fund, its managers and the fund's investment objectives.

One area that often is included in private equity fund PPMs and related supplemental documents is the track record of the investment team. Investors typically will select and stay with managers who have demonstrated consistent successful investing results. Because this can put pressure to make the track record appear as positive as possible, the SEC looks closely at track records and accompanying disclosures to ensure there are no material omissions or false or misleading statements. To help ensure that disclosures are meaningful and comprehensive, consider the following non-exclusive list of guidelines:

- Track record disclosure must be based on the investment team managing the new fund.
- The metrics used to disclose track record varies, but most typically is expressed in terms of internal rate of return and cash-on-cash returns,
- Use net-of-fee returns to help investors get a more realistic picture of what the return actually will be. As an option, you also could include both net-of-fee and gross-of-fee return figures.
- If the funds being used to show track record have different compensation structures, the PPM should take a conservative approach by applying the highest compensation structure across all of the examples.
- Track record information can include both realized and unrealized returns measured as of the most recent calendar quarter.
- Track record information should be updated as appropriate to ensure that the information remains accurate and current.
- Selective disclosure must be avoided. Be sure to not just cherry pick the attractive performance returns; show all. Where selective deal summaries are used, selection should be based on objective criteria and the disclosure should be tied to the complete list disclosure.
- Decisions on what time periods to cover in track record disclosure should be made on objective criteria.

Sometimes a manager may wish to include information in a PPM on the track record of investment professionals that occurred while they were with previous employers. To include such disclosure, the investment professional must have been primarily responsible for the investment decisions at the prior fund, and the PPM must include all funds/accounts previously managed so as to avoid cherry picking. From a substantive perspective, such information should only be included in a PPM if it was based on investment strategies that are substantially similar to the investment strategies of the fund that is the subject of the PPM. It is also important that any confidentiality restrictions with the previous employer are dealt with before including the track record disclosure.

Pitch Books

Pitch books contain abbreviated disclosure about an offering and are often drafted in PowerPoint slides. A manager may utilize a pitch book to pre-market a fund and for various investor presentations. Since pitch books are an abbreviated version of the PPM, it is important that the contents be carefully screened for any information that is not contained in the PPM to determine whether that information is material to an investment decision and should be included in the PPM. Pitch books should contain legends and disclaimers tying the information in the pitch book to the more fulsome disclosure in the PPM and directing the reader to access such information.

Managers may be tempted to customize the pitch book for all or select potential investors. While this approach may enhance the interest of an investor, the practice may lead to inconsistent information being disseminated in connection with the offering. If customized pitch books are used, care should be taken that the substantive disclosure is consistent across the pitch books and with the PPM. To manage that process, managers should consider designating one team member as the point person for such disclosures and have them work closely with legal counsel to ensure the overall integrity of the materials being utilized in the offering.

Due Diligence Questionnaires

Many investors will require managers to respond to a due diligence questionnaire which seeks out a wide range of information that may or may not be included in the PPM. Requests for information in due diligence questionnaires may include requests for extremely detailed data regarding performance, personnel, operations of the firm and material and non-material litigation. Sometimes managers will prepare pre-emptive due diligence questionnaire and responses in hopes of avoiding the burden of having to respond to many unique questionnaires. Regardless of format, take steps to ensure that the responses are accurate, that material disclosures are provided and that material information is not omitted.

Data Rooms

A data room is a centralized location having a host of documents for potential investors to review when evaluating whether to commit capital to a fund. Historically, data rooms have consisted of designated locations containing hard copies of documents. In recent years, data rooms are typically provided through dedicated online web portals. Online data rooms have the advantage of permitting almost instantaneous access to documents by investors as well as an enhanced ability to grant and restrict access to all or a portion of the data room and to track what documents are being accessed through the portal.

Typically, the data room contains client disclosure documents, such as the PPM, the fund's limited partnership agreement and the subscription agreement and other related fund documents. Often, data rooms will contain summaries of investments made by predecessor funds and examples of reports and audited fund financials. Managers need to work with legal counsel to determine if the materials placed in the data room could be viewed as advertisements. To help clarify intent, all documents in the data room should have an appropriate legend affixed to them stating that the materials in the data room are for the limited purpose of illustrating the actual operations of the firm.

If a data room is utilized, it is best practice to grant access to all potential investors to avoid the appearance of selective disclosure. It is also important to keep the data room up to date. Tip: Appoint one person to oversee the periodic maintenance and operation of a data room.

Conclusion

It is critical that managers approach the promotion of their private equity fund with care and attention to details in the fund documents and marketing materials. For newer fund managers, service providers such as knowledgeable securities counsel, independent auditors and placement agents can be good sources for assistance in structuring the fund and designing and executing an effective marketing plan. For more information on marketing and promotional considerations for private equity funds, please contact us at 619.298.2880 or at info@jackolg.com.

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